Supreme Court, U.S.
FILED
MAY 7 1988
JOSEPH F. SPANIOL, JR.
CLERK

No. 87-600

In The
# Supreme Court of the United States
October Term, 1987

VARIABLE ANNUITY LIFE INSURANCE COMPANY, *et al.*,
*Petitioners,*

v.

BEVERLY J. OTTO, INDIVIDUALLY AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED, *et al.*,
*Respondents.*

**ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT**

## SUPPLEMENTAL BRIEF OF RESPONDENTS IN RESPONSE TO BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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This brief is filed in response to the Brief for the Solicitor General as Amicus Curiae filed pursuant to the Court's invitation.

## STATEMENT

The Solicitor General ("SG") raises two reasons why it supports this Court's granting the petition for certiorari: (1) the SG "believes the court of appeals' legal analysis is wrong" (SG Brief at p. 5) and its reasoning "unclear" (SG Brief at p. 6); and, (2) "This case has caused great interest and concern in the insurance industry. . . . The Court's opinion could . . . provide valuable

guidance to the lower courts and the industry as to the proper standards by which to judge these products." (SG Brief at p. 5). The Solicitor General's stated reasons for granting certiorari are not only inadequate, but more importantly, they are inaccurate on the facts of this case and the governing law.

There is no relationship between the product the Solicitor General describes in its Brief and on which it bases its analysis, and the "Tax Deferred Investment Program" marketed and sold by The Variable Annuity Marketing Company ("VAMCO"), a wholly-owned marketing subsidiary of The Variable Annuity Life Insurance Company ("VALIC"). The Solicitor General describes a stand-alone annuity which is not present here. The "Tax Deferred Investment Program" here had the following distinguishing relevant elements, none of which were fully discussed or analyzed by the Solicitor General, thereby rendering its conclusions fallacious.

1. The program is entitled "Tax Deferred Investment Program."

2. The "Tax Deferred Investment Program" provides that an investor could invest his money in the "fixed" accumulation account or in the variable accumulation account, or in a combination of the two. Further, the investor, at his option, could switch from fixed to variable and back again at any time without penalty. Thus, one of the things purchased by an investor was the option of investing (as admitted by VALIC in oral argument before the Court of Appeals) in a security, namely, the variable annuity (*see SEC v. VALIC,* 359 U.S. 65 (1959) (*"VALIC I"*)).

3. The "Tax Deferred Investment Program" was sold, not by VALIC itself, but by VAMCO. VAMCO's employees are not insurance agents, but licensed members of the National Association of Securities Dealers ("NASD"), which they must be to sell the con-

tract that contains the variable annuity held to be a security in *VALIC I*. VAMCO is not subject to regulation by the Illinois insurance department; nor was it otherwise subject to Illinois laws since it never qualified to do business within the state. In addition, the fixed accumulation account portion of the "Tax Deferred Investment Program" sold by VAMCO and issued by VALIC was not the subject of any regulation by the State of Illinois, where this class is certified.

4. VALIC only guaranteed a nominal interest rate of 4%. VAMCO, in marketing the product, emphasized VALIC's investment expertise which enabled it to pay interest ("the highest current rate") far greater than that guaranteed. The excess interest was at the total discretion of VALIC, and could be terminated or reduced at any time. VALIC misled Otto and the lower courts by failing to disclose that the excess interest rates were banded, and that VALIC could change the rates on past bands at any time to shift any investment risk from itself to the purchaser.

5. VALIC's guarantee of 4% (dropping to 3½%) on funds invested came at a time when market rates were as high as 14½%. At such a time, the investment risk on VALIC was therefore only for the guaranteed 4%, while the investment risk on the investor was for the wholly discretionary 10½%. At no time pertinent to this case was the percentage risk to VALIC higher than the percentage risk to the investor in the so-called "fixed" account.

VALIC's "Tax Deferred Investment Program" is a far cry from what the Solicitor General calls a "fixed annuity with a discretionary-interest component." SG Brief at p. 5. The Solicitor General's inaccurate characterization as to the nature of the product involved here distorts its subsequent analysis (as well as its Question Presented), and renders its advice to the Court suspect.

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## DISCUSSION

### I. The Court of Appeals' Decision Conforms With The Decisions of This Court, and Does Not Conflict With the Decision of Any Other Court of Appeals or With the SEC's Own Published Standards.

Significant by its absence from the Solicitor General's list of reasons for granting certiorari is any claim that the Court of Appeals' decision conflicts with any decision of this Court, including *VALIC I* and *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202 (1967) (*"United Benefit"*), nor any decision of the other court of appeal. There is good reason for this. *No new law was established by the Court of Appeals here in its final decision.* This factor mitigates heavily in favor of denying certiorari.

Neither can the Solicitor General point to any portion of any SEC Release or Rule with which the Court of Appeals' decision conflicts. Instead, the Solicitor General only takes issue with the clarity of the Court of Appeals decision, not the result. The Solicitor General does not say that the end result obtained here was erroneous. *See* SG Brief at p. 10.

It is the Solicitor General's reasoning which lacks clarity and consistency with the SEC's past pronouncements in this area. In its analysis of the status of VALIC's "Tax Deferred Investment Program" outside the safe harbor of Rule 151, the Solicitor General surprisingly states: "The lack of a meaningful mortality risk is not necessarily a disqualifying feature." SG Brief at p. 10. The Solicitor General's position is totally inconsistent with the long history of exemption of traditional insurance products under Section 3(a)(8) based in large part on that very factor. In adopting the objective test of Rule 151 as a safe harbor under Section 3(a)(8), the SEC traded off mortality risk for a one-year guarantee of

excess interest rates. Outside of the safe harbor, security status is still determined in reference to the "total facts and circumstances" test, in force under Release 6051. More importantly, and wholly ignored by the Solicitor General in its quest for an advisory opinion unrelated to the facts of the case, the governing law during the time period of the facts of this case was SEC Release 6051, under which, in the words of the SEC:

> "These risks are of two kinds—mortality risks and investment risks. A significant assumption of both kinds of risks is required, in the Commission's view, for a contract to be exempt pursuant to Section 3(a)(8) from the full disclosure and prospectus delivery requirements of the Act.
>
> * * *
>
> A contract which does not place upon the issuing insurance company a meaningful mortality risk cannot be regarded as 'life insurance' or an 'annuity' for purposes of the federal securities laws."

Respondent is at a loss to explain this oversight on the part of the Solicitor General. Release 6051 is nowhere mentioned in the Solicitor General's Brief. Is the federal government now ready to abandon the regulation of securities sold under the name of "annuities" so long as they are sold by insurance companies?

On the key issue of investment risk as a factor in determining security status, the Solicitor General states:

> "At least where, as here, a state-regulated insurer assumes all risk with respect to principal and with respect to an adequate fixed rate of interest, and guarantees payment of all discretionary excess interest declared under the contract, the investment-risk criterion is satisfied." SG Brief at pp. 8-9.

The Solicitor General's conclusion is directly contradicted by SEC Release 6051 as follows:

> "Certain guaranteed investment contracts promise a relatively low rate of interest will be credited on accumulating funds but also provide for crediting of discretionary excess interest, and the contract is sold by placing emphasis on the possibility that high discretionary interest will be credited. *In economic reality the insurer issuing such a guaranteed investment contract is asking the potential purchaser to assume the risk that, after the expiration of an initial guarantee period during which high discretionary interest will be credited, interest to be credited will fall to the much lower guaranteed rate.* Advertisements sponsored by insurance companies or authorized salespersons (such as broker-dealers) which emphasize high current discretionary excess interest and relegate mention of traditional annuity features to fine print must be viewed as intended by the sponsors to encourage investment in guaranteed investment contracts principally by those investors who desire to assume the investment risk discussed above because their investment objective is to maximize tax-deferred capital accumulation rather than to acquire conventional annuity plans." (Emphasis added.)

The Solicitor General has misapplied the concept of "investment risk" in its Brief to this Court. Investment risk, as Rule 151 and Release 6051 make clear, is the risk that the excess interest will be paid in the future after investment, not whether the principal and credited interest will be collected by the participant. The latter is a solvency argument, but the solvency of the issuer to pay principal and credited interest is irrelevant to the investment risk the investor assumes.

The stance of the Solicitor General that state regulation is sufficient protection for investors is in marked contrast to the SEC's position in Release 6050, where it stated:

> "The existence of state authorities who have certain regulatory powers and responsibilities for their respective states does not relieve the Commission of its duty and responsibility to administer the full disclosure and prospectus delivery requirements of the Act where the contract being sold is not exempt pursuant to Section 3(a)(8)."

The Solicitor General's reliance on state regulation of insurance companies for protection of investors and its claim that the "purpose of the securities laws is to ensure that investors in securities are fully and accurately informed about the issuer and the investment's relevant features, including its risks," SG Brief at p. 7, is contrary to this Court's prior holdings. State regulation of the insurance industry is designed to protect against insolvency of the insurance companies. The federal securities laws are designed to provide the investor with full disclosure to allow her to make an informed choice as to her investment decisions, and to provide the investor with effective remedies for fraudulent representations concerning such investments. *See* VALIC I, 359 U.S. at 77-78 (Brennan, J., concurring). It is the picture that the Solicitor General paints that is in conflict with the decisions of this Court and the SEC's own past declarations in this area, and not the Court of Appeals decision.

## II. The Solicitor General Seeks An Advisory Opinion On Fixed Annuities.

The Solicitor General states that many different types of annuity products are now being sold by the industry and that an opinion in this case will "not necessarily resolve the application of the securities laws to all so-called fixed annuities." SG Brief at p. 5. It nevertheless says that an opinion could provide "valuable guidance to the lower courts and the industry as to the proper standards by

which to judge these products." *Id.* Other issues the Solicitor General would like an advisory opinion on, but which have never been raised in this case and which are totally irrelevant, are whether, if this product is a security, VALIC "is subject to the registration provisions of the Securities Act," whether VALIC "and its agents must comply with the broker-dealer provisions of the Securities Exchange Act" (a non-issue since they already comply), and whether VALIC "may lose its 'insurance company' exemption under the Investment Company Act of 1940." SG Brief at pp. 5-6.

Advisory opinions on securities issues, in the form of Rules and Releases, are, and should be, the responsibility of the SEC pursuant to its rule-making authority, and the Solicitor General should not be allowed to abdicate the SEC's role by shifting the responsibility to the Court, especially under the unique and limited circumstances of this case. The position of the Solicitor General is particularly surprising since it claims that the record may be inadequate for a review in at least two areas. SG Brief at pp. 9-10. These two areas are marketing (whether the contract was sold as a security) and meaningful mortality risk (whether VALIC was subject to such).[1] In spite of this, the Solicitor General suggests the Court grant certiorari so that guidance can be given. In short, an advisory opinion is being requested.

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[1] The SG is inaccurate regarding the incompleteness of the record on these two points. The record contains sales literature of the defendants, together with acknowledgments, reports, letters, etc. that show that VALIC through VAMCO went to great lengths to sell an *investment* to its customers, not an annuity. As to the mortality risk, VALIC assumed none. This can be seen from a reading of the contract itself. In short, the record is sufficient on both of these issues for purposes of this Court review.

## III. The Court of Appeals Correctly Held VALIC's "Tax Deferred Investment Program" To Be A Security Under Section 3(a)(8).

The Solicitor General states, in its Brief at p. 6, "The reasoning of the Court of Appeals is unclear." The Solicitor General's Brief gives the impression that the Court of Appeals relied entirely on VALIC's failure to qualify under Rule 151 in holding its "Tax Deferred Investment Program" is a security. This is incorrect. Rule 151 was the most liberal of all the methods VALIC had available to it to attempt to turn its "Tax Deferred Investment Program" into an exempt insurance product. VALIC therefore insisted that the court should look to that Rule as the applicable criterion, not Release 6051, which was the governing standard for the time period involved in this case. Rule 151 represented, said VALIC, the current view of the SEC as to when a contract became a security, especially as to the investment risk factor.

VALIC was forced to confess that it could, at its unfettered discretion, change or eliminate the excess interest payable at any time—and therefore could not comply even with Rule 151's most liberal requirements. After VALIC admitted that it had misled the Court of Appeals and Otto, the court re-examined its conclusion. As a result, the court found that since VALIC could change the excess interest payable at any time, the investment risk shifted primarily on the investor. The court had indicated in its original opinion, in ruling for VALIC, that the call was close. Once VALIC was forced to reveal all the facts, the court found that VALIC no longer should prevail.

The Solicitor General claims that the court's second decision was decided "solely because the fixed annuity

did not satisfy one element of the test set forth in the Commission's Rule 151 . . ." SG Brief at p. 6. This is totally erroneous. The court's initial decision was not bottomed on Rule 151, but on the status of the contract under the securities laws. In its order of January 29, 1987 (Respondents' Brief in Opposition, App. 1), the Court of Appeals said:

> "If VALIC did, in fact, have the right to reduce the banded interest rates, our determination that the fixed annuity was an exempt insurance product not subject to the federal securities laws may be flawed. Whether VALIC possessed this discretion certainly is important to the level of investment risk assumed by VALIC. In addition, our opinion relied in part on the fixed annuity's satisfaction of all of Rule 151's 'safe harbor' requirements. One of those requirements apparently would not be met if VALIC had the authority to change the interest bands. The failure of the fixed annuity to qualify for safe harbor treatment under Rule 151 would not require us to find that the fixed annuity was a security, both because the Rule technically does not cover annuities for the time period in question *and because the rule does not purport to provide an all-inclusive definition of all annuities that are exempt from the federal securities laws.* Nevertheless, the failure of the fixed annuity to satisfy any prong of Rule 151 clearly is relevant to and requires a reevaluation of the status of the annuity." Respondent's Brief in Opposition, App. 5. (Emphasis added.)

As this language shows, the court did not rely entirely on Rule 151 for its decision. The court recognized that it had to examine the instrument under the broad rules of the securities acts, not just the narrow safe-harbor provisions. In its original opinion the court acknowledged that VALIC had come close to crossing the line. It said:

> "The difference between the plan before us and the one considered in *Peoria Union* [*Stock Yards Co. v. Penn Mutual Life Insurance Co.*, 698 F.2d 320 (7th Cir. 1983)] [where the product was held to be a security] is not enormous, but the balance of the investment risk has been sufficiently shifted to the insurance company to justify a different result here." *Otto v. VALIC*, 814 F.2d 1127, 1132 (7th Cir. 1987).

When VALIC was forced to admit that the investment risk was not what had been represented to the court, the court concluded that VALIC had therefore gone over the line. Said the court in its opinion on rehearing:

> "The amount of discretion retained by VALIC to alter the interest it paid under the fixed annuity is relevant to the level of the investment risk assumed by VALIC. As discussed in our previous opinion, the Supreme Court, this circuit and the Securities and Exchange Commission (the "SEC") all have found that the degree of investment risk assumed by the insurance company is an important factor in determining whether a particular annuity plan is an insurance product or a security." 814 F.2d at 1141.

The court then discussed *VALIC I* and *United Benefit*, along with the *Peoria Union* case and Rule 151. *Id.* The court concluded:

> "We find that on the facts of this case the minimum interest rates guaranteed under VALIC's fixed annuity plan, although they are somewhat in excess of those required by Rule 151, alone do not place the investment risk on VALIC sufficiently to exempt the plan from the federal securities laws. To find otherwise we would have to overlook entirely any requirement for a guarantee of excess interest. To do this would be to disregard completely one element contained in the investment risk test of the SEC's safe harbor Rule 151. Admittedly this is not an element relied on previously in court decisions distinguishing securities from insurance products. But it is an ele-

ment the SEC has insisted on over the objection of some commentators." *Id.* at 1142.

If any question still remains as to the role of Rule 151 in the court's reasoning—and its secondary importance —then the order amending the second opinion made this clear:

> "Because Rule 151 was cited to us by VALIC as a relevant test, we are unwilling to ignore it to the degree urged by VALIC. We do not say that Rule 151 defines the meaning of 'security'; it is a safe harbor rather than a definitional rule, as our first opinion observes, *see supra* at 1133 n.2. But VALIC's argument directly under the statute depends on its assertion that the guaranty of return here requires calling the instrument insurance under Sec. 3(a)(8) even if the prospect of 'excess' interest is a principal inducement to purchase this particular instrument. Because the contract actually leaves the investor with an investment risk significant enough to throw its status into doubt, VALIC's argument in this court effectively depended on its own analogy to the standards of Rule 151, which has not sufficed." *Id.*

There is nothing unclear about the court's decision and it conforms entirely with this Court's decisions in this area.

## IV. Additional Grounds Exist Under The Securities Laws For Holding "The Tax Deferred Investment Program" To Be A Security

A number of additional grounds exist for finding the contract to be a security under the securities laws that were not discussed or responded to in the Solicitor General's Brief. These additional grounds are fully presented in Respondent's Brief in Opposition, were presented to the court below, and include the grounds that: the "fixed annuity" here is an option on a security, the variable annuity, and therefore is itself a security (SEC

Release 6558); and, that this case involves the "Tax Deferred Investment Program" at the "accumulation phase" of the contract, and not the annuity or "pay-out" phase (*United Benefit*). Both grounds independently support the result of the Court of Appeals' opinion, and support the denial of the petition for certiorari in the case.

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## CONCLUSION

As stated in Respondents' Brief in Opposition (pp. 15-18), this is a case of great importance only to VALIC and to the plaintiffs. At this stage the decision is interlocutory. Damages have not been assessed and numerous pleading and procedural issues are still outstanding. The need for certiorari is nonexistent. The Petition for Writ of Certiorari should be denied.

Respectfully submitted.

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